NATIONAL
ENERGY
MARKETERS
ASSOCIATION

NATIONAL GUIDELINES
FOR
UNBUNDLING AND RESTRUCTURING
THE
NATURAL GAS
DISTRIBUTION FUNCTION

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This document reflects the views of the National Energy Marketers Association and does not necessarily reflect the views of any specific member of the Association.

National Guidelines to Competitively Restructure the Market for Natural Gas and Related Products and Services

I
Introduction

The National Energy Marketers Association (NEMA) is a national, non-profit trade association representing a regionally diverse cross-section of both wholesale and retail marketers of natural gas and electricity. NEMA also represents producers, generators, transporters, and marketers of energy-related information, services and technology throughout the United States.

NEMA is committed to working with representatives of state and federal governments, large and small consumer groups and utilities to devise fair and effective ways to implement restructuring of natural gas and electricity markets. NEMA and its members appear before state Public Utility Commissions, the Federal Energy Regulatory Commission and legislative bodies throughout the nation. NEMA members urge lawmakers and regulators to implement:

- Laws and regulations that open markets for natural gas and electricity;
- Rates, tariffs and operating procedures that lower the cost of energy;
- Standards of conduct that protect consumers;
- Rules to permit competition on the basis of price and quality of service; and
- Policies that encourage new technologies, including the integration of energy, telecommunications and Internet services.

II
Background

The day after President Reagan was sworn in as President of the United States, he issued an Executive Order that decontrolled the price of crude oil. Since that day, the real prices of crude oil and related products such as gasoline have declined to historic lows. Similarly, as price controls were lifted from airline travel and trucking, prices for these services have declined significantly.

Natural gas was first discovered as a by-product of crude oil production. For many years, it was considered a nuisance, of no value and very expensive to transport. As a result, it was often flared at the wellsite. Today, natural gas is considered one of the lowest cost, cleanest, most efficient burning fossil fuels and is used widely in all sectors of the U.S. economy. Unfortunately, after a decade and a half of natural gas deregulation, fewer than five percent of all homeowners and small businesses are permitted by law to purchase natural gas in a competitive marketplace.

Unlike crude oil, significant investment in long distance, high-pressure pipelines, compressing stations and processing plants are required to prepare and to transport commercial grade natural gas from its production site to its consumption point. Historically, it has been considered inefficient to build multiple interstate pipelines to transport natural gas out of producing areas. Similarly, it has been considered economically inefficient to dig up city streets to build multiple competing small pipelines (distribution facilities) to deliver gas to end users. Consequently, the physical act of shipping natural gas from its production site to its consumption point involves two distinct and legally separate natural monopoly functions—transmission and distribution.[i]

In 1938, Congress passed the Natural Gas Act to protect consumers against the monopoly power inherent in large pipeline companies controlling the transmission of natural gas in interstate commerce.[ii] Ultimately, the Supreme Court extended this regulation to the price of natural gas itself.[iii] Before federal price controls were extended to natural gas, it sold in many markets for as little as 10 cents per thousand cubic feet (Mcf) or less. By the time price controls on crude oil were phased-out, natural gas that was sold under government-mandated contracts, had reached prices in some markets as high as $10 per Mcf. This 10,000 percent increase in the price of natural gas caused so many distortions in both its production and use that Congress and federal regulators began a difficult, fifteen-year restructuring process.[iv]

Today, natural gas is traded freely on the commodity markets like other commodities.[v] Implementation of FERC Order 636, legally separated (unbundled) the regulated interstate pipeline transmission function from the competitive functions involved in marketing the natural gas commodity and related services to local distribution utilities (LDCs) and many large industrial consumers. As a result, the price of natural gas to LDCs and large industrial consumers has declined on average by as much as forty to fifty percent.

A number of states have initiated test programs to permit small numbers of consumers competitive choices for purchasing natural gas services. However, as of today, 95% or more of all homeowners and small businesses in the United States have no competitive choices and have received little, if any price reduction from the decontrol of natural gas prices.[vi] One reason is that the last natural monopoly function of transporting natural gas through small, low-pressure pipelines from the interstate market to the residential and small business customer has not been legally separated from the competitive functions involved in marketing natural gas and related products and services. Another reason is that numerous utility-related switching fees plus charges for uneconomic utility investments called "stranded costs" have been added onto the competitive price for natural gas delivery and have discouraged or prevented small consumers from switching to competitive suppliers.

III
National Guidelines for Competitive Sales of Natural Gas and Related Products, Services and Technology

To implement the next phase of natural gas restructuring will require state PUCs throughout the United States to legally separate the regulation and pricing of the natural gas distribution function from a host of other products and services currently bundled in the price of the natural monopoly function. This is necessary to permit all homeowners and small business to choose from the numerous competitive and innovative products and services that are available to bring natural gas from the wellhead to the burnertip. The National Energy Marketers Association (NEMA) urges lawmakers, regulators and policymakers to extend the benefits of customer choice and price competition to all consumers at the earliest possible date.

The following *National Guidelines for Unbundling the Natural Gas Distribution Function* represent the minimum specific products and services that must be separated from the provision of local distribution pipeline transportation in order to provide all American consumers the benefits of innovation and competition on the basis of price and quality of service. Members of the National Energy Marketers Association are ready, willing and able to bring to the American public each of these important products, services and technologies as soon as regulators implement the following principles at the state PUC level.

IV
Products, Services and Technology That Must be Legally Separated and Competitively Priced to Benefit all Consumers

State economic regulation of the true distribution monopoly function reduces costs to society by eliminating unneeded duplication and by preventing utilities from extracting monopoly profits. Therefore, by definition, limiting regulation to the natural monopoly function while permitting robust competition on all other functions, products, services and technology should maximize benefits of innovation, lower prices and provide a higher quality of service, while minimizing the economic distortions inherent in monopoly economics. Additionally, as regulated utilities fully unbundle energy supply and service functions, the provider-of-last-resort functions can be provided by qualified suppliers and the *obligation to serve* can be modified into an *obligation to deliver.*

To achieve a competitive natural gas market it is imperative that state lawmakers and regulators implement the following uniform standards governing utility unbundling to provide homeowners and small businesses reliable, low cost and high quality natural gas-related products, services, information and technology.

- **All consumers must be permitted to purchase energy and related products, services and technologies with a minimum of red tape and paperwork burdens.**

- **Any collection of consumers must have the right to voluntarily aggregate, select a third party to service all or any portion of their natural gas supply needs and receive a price for utility transportation services as a single load on a uniform, non-discriminatory basis.**

- **All consumers must be given the option to receive one bill from a supplier of choice.**

- **Artificial barriers to competition such as unreasonable administrative charges, access fees, switching fees, creditworthiness standards, aggregation and pooling charges or anti-competitive telemetering requirements must be prohibited.**

- **Regulated utilities should sell regulated distribution services, on a cost of service basis and unbundle other services.**

- **All regulated utility distribution services must have rate certainty and be provided on a non-discriminatory, cost-basis pursuant to filed tariffs.**

- **All load management tools previously available to local distribution utilities should be separated from regulated distribution services and properly priced and available on a non-discriminatory and optional basis to all competitive suppliers.**

- **NEMA's *Uniform Code of Conduct Governing Commercial Transactions Between Regulated and Unregulated Entities* should be adopted and effectively enforced in all jurisdictions.**

- **Stranded cost recovery charges for unneeded upstream capacity, must only reflect prudently incurred, aggressively mitigated costs that are fairly allocated to all classes of customers**

In order to provide homeowners and small businesses with reliable, low cost, high quality, natural gas and related services, the following services, that are bundled in the price of natural gas distribution rates, must be legally separated, priced and competitively available on a nondiscriminatory basis.

- **A competitive natural gas market requires that allocation of interstate natural gas pipeline capacity be optional.**

- **A competitive natural gas market requires charges for injection, storage and withdrawal of natural gas to be separated and available on a non-discriminatory and optional basis to all competitive suppliers.**

- **A competitive natural gas market requires that gas be capable of being traded among numerous buyers and sellers. Toward this end, tariffs to implement choice should be structured to maximize market liquidity.**

- **A competitive natural gas market requires reasonable rules, conditions and tolerances for the physical delivery of natural gas,**

- **A competitive natural gas market requires that charges, if any, for balancing and similar functions performed by a utility should be cost-based. Balancing and similar functions should be offered on a non-discriminatory and optional basis to all competitive suppliers.**

- **A competitive natural gas market requires that curtailment rules be established to recognize property rights to the maximum extent possible. When such recognition is not possible, full compensation should be made to those whose rights have been breached.**

- **A competitive natural gas market requires charges for and optional allocation of peaking supplies to be available on a non-discriminatory and optional basis to all competitive suppliers, and**

- **A competitive market must have effective, enforceable and objective standards for measuring the availability of transmission capacity and penalties for the prevention of anti-competitive control of constrained delivery points.**

V
Conclusion

The right to switch energy suppliers is the ultimate consumer protection. Choice must exist in order to serve the public interest and it should not be complicated or expensive. A true measure of a competitive market is the number of customers that have choice and the number of providers ready to serve those customers. One measure of the quality of choice is the number of customers that, in fact, exercise choice. The National Energy Marketers Association urges that all customers be given meaningful, competitive choices at the earliest possible date.

The National Energy Marketers Association is committed to the implementation of laws, regulations, standards of conduct, rates, tariffs and operating procedures (a) that provide all customers meaningful choice, (b) implement open, efficient, liquid and price-competitive energy markets, and (c) that encourage the development of new and innovative energy services and technologies, at the earliest possible date.

Competitively priced energy and related services will serve the public interest, save consumers, governments and taxpayers billions of dollars and will promote significant efficiency, innovation and productivity gains, nationwide. However, to bring the benefits of competition to the American public, historically regulated utility services must be offered separately ("unbundled") from products and services that may be offered by competitive suppliers and subjected to the rigors of the marketplace.

ENDNOTES

i. The Federal Energy Regulatory Commission (FERC) regulates the interstate transportation (transmission) of natural gas in high pressure, long distance pipelines to the city gate. The transportation of natural gas from the city gate to the consumption point through low-pressure lines is called the local distribution function and is also considered a natural monopoly. Local distribution companies (LDCs) are regulated by state public service commissions (PUCs). Both the FERC and state PUCs regulate the price of these monopoly functions on a cost of service plus a regulated rate of return basis. Similarly with electricity, the FERC and state PUCs regulate the interstate transmission and local distribution functions respectively. One definition of a natural monopoly is when, because of the high ratio of fixed costs to variable costs, a single firm has declining costs at the level of demand in the industry, such that the single firm can supply the service more cheaply than two firms could. Richard A. Posner, Economic Analysis of Law, Section 12.1, at 343-45 (4th ed. 1992). Unbundling the natural gas (and electric) transmission and distribution functions permits society to maximize benefits by receiving the lowest cost for the specific monopoly function of transporting natural gas through the interstate and local pipelines while at the same time permitting numerous firms to compete on the basis of price and quality of service to provide non-monopoly services.

ii. The Natural Gas Act (NGA), ch. 556, 52 Stat. 821 (1938) (codified as amended at 15 U.S.C. Sections 717-717w (1994)) gave the Federal Power Commission (FPC), now the Federal Energy Regulatory Commission (FERC), jurisdiction over sales for resale in interstate commerce and over interstate transportation of gas, but left the regulation of local distribution to the states.

iii. *See: Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672, 677-84 (1954).

iv. After attempting decontrol by regulation under the Natural Gas Policy Act of 1978, Congress implemented the process of deregulating producer sales of natural gas by enacting the Natural Gas Wellhead Decontrol Act of 1989, Pub L. No. 101-60, 103 Stat. 157. To make natural gas price decontrol effective, Congress relied in major part on the ultimate success of the FERC to implement the legal separation and competitive unbundling of the interstate natural gas transmission function from the competitive function of marketing natural gas and related services. This process of legally separating the interstate transmission function from the natural gas marketing function began with a series of FERC Orders Numbered 436 through 636. The following series of FERC Orders gave rise to what is now known as the Natural Gas Marketing Industry. ***See:*** Order No. 436, Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, [Regs. Preambles 1982-85] F.E.R.C. Stats. & Regs. (CCH) ¶ 30,665 *order on reh'g*, Order No. 436-A, [Regs. Preambles 1982-85] F.E.R.C. Stats. & Regs. (CCH) ¶ 30,675 (1985), *order on reh'g*, Order 436-B, [Regs. Preambles 1986-90] F.E.R.C. Stats. & Regs. (CCH) ¶ 30,688, *order on reh'g*, Order No. 436-C, 34 F.E.R.C. ¶ 61,404, *order on reh'g*, Order No. 436-D, 34 F.E.R.C. ¶ 61,405, *order on reh'g*, Order No. 436-E, 34 F.ER.C. ¶ 61,403 (1986) *vacated and remanded sub nom. Associated Gas Distributors v. FERC*, 824 F.2d 981 (D.C. Cir. 1987) (AGD I), *cert. Denied*, 485 U.S. 1006 (1988). ***See also:*** Order no. 500, Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, [Regs. Preambles 1986-90] F.E.R.C. Stats. & Regs. (CCH) ¶ 30,761 *order on reh'g*, Order No. 500-A, [Regs. Preambles 1986-90] F.E.R.C. Stats. & Regs. (CCH) ¶ 30,770 *order on reh'g*, Order No. 500-B, [Regs. Preambles 1986-90] F.E.R.C. Stats. & Regs. (CCH) ¶ 30,772 *order on reh'g*, Order No. 500-C, [Regs. Preambles 1986-90] F.E.R.C. Stats. & Regs. (CCH) ¶ 30,786 *order on reh'g*, Order No. 500-D, [Regs. Preambles 1986-90] F.E.R.C. Stats. & Regs. (CCH) ¶ 30,800 *order on reh'g*, Order No. 500-E, 43 F.E.R.C. ¶ 61,234, *order on reh'g*, Order No. 500-F, [Regs. Preambles 1986-90] F.E.R.C. Stats. & Regs. (CCH) ¶ 30,841(1988), *order on reh'g*, Order No. 500-G, 46 F.E.R.C. ¶ 61,148, *vacated and remanded sub nom. American Gas Ass'n v. FERC*, 888 F.2d 136 (D.C. Cir. 1989) (AGA I), Order No. 500-H, [Regs. Preambles 1986-90] F.E.R.C. Stats. & Regs. (CCH) ¶ 30,867 (1989) *order on reh'g*, Order No. 500-I, [Regs. Preambles 1986-90] F.E.R.C. Stats. & Regs. (CCH) ¶ 30,880, *remanded sub nom. American Gas Ass'n v. FERC*, 912 F.2d 1498 (D.C. Cir. 1990) (AGA II). ***See also:*** Order No. 500-K F.E.R.C. Stats. & Regs. (CCH) ¶ 30,917, reh'g denied, Order 500-L, 55 F.E.R.C. ¶ 61,489 (1991). ***See also:*** Order No. 528, Mechanisms for Passthrough of Pipeline Take-or-Pay Buyout and Buydown Costs, 53 F.E.R.C. ¶ 61,163 (1990), *order on reh'g*, Order No. 528-A, 54 F.E.R.C. ¶ 61,095, *order on reh'g*, Order 528-B, 55 F.E.R.C. ¶ 61,372 (1991). ***See also:*** Order Nos. 636, 636-A, and 636-B. Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation; and Regulation of Natural Gas Pipelines after Wellhead Decontrol, [Regs. Preambles 1991-96] F.E.R.C. Stats. & Regs. (CCH) ¶ 30,939, et. Seq., [hereinafter cited as *Order No.* 636].

v. It should be noted that many experts believe that natural gas is the most volatile commodity on the New York Mercantile Exchange.

vi. According to the Energy Information Agency, between1984 to 1995 wellhead natural gas prices-declined from an average of $2.66 to $1.55; citygate prices declined from $3.95 to $2.78; prices to industrial consumers declined from $4.22 to $2.71, and prices to electric utilities declined from $3.70 to $2.02/ Mcf. However, average prices to residential customers between 1984 and 1995 declined from $6.12 to $6.06 per Mcf.

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